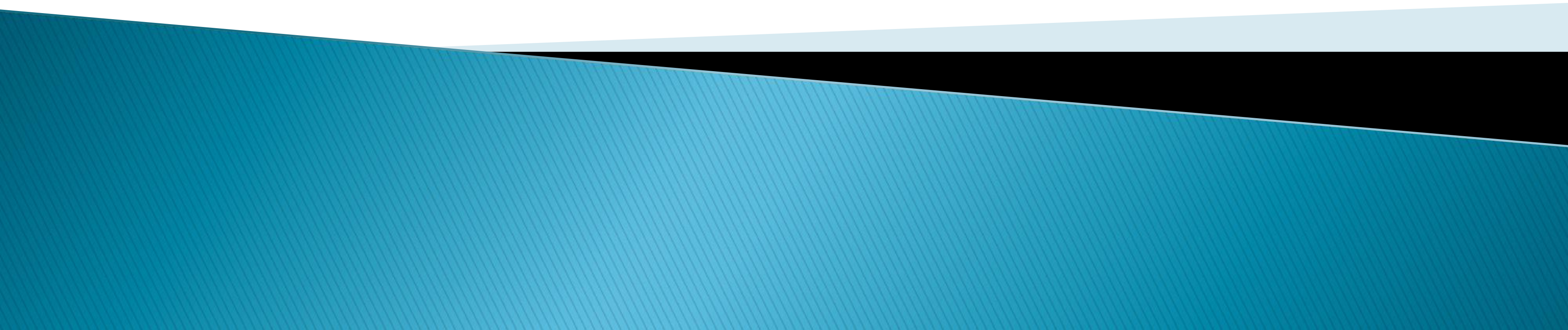
# The Federal Reserve System



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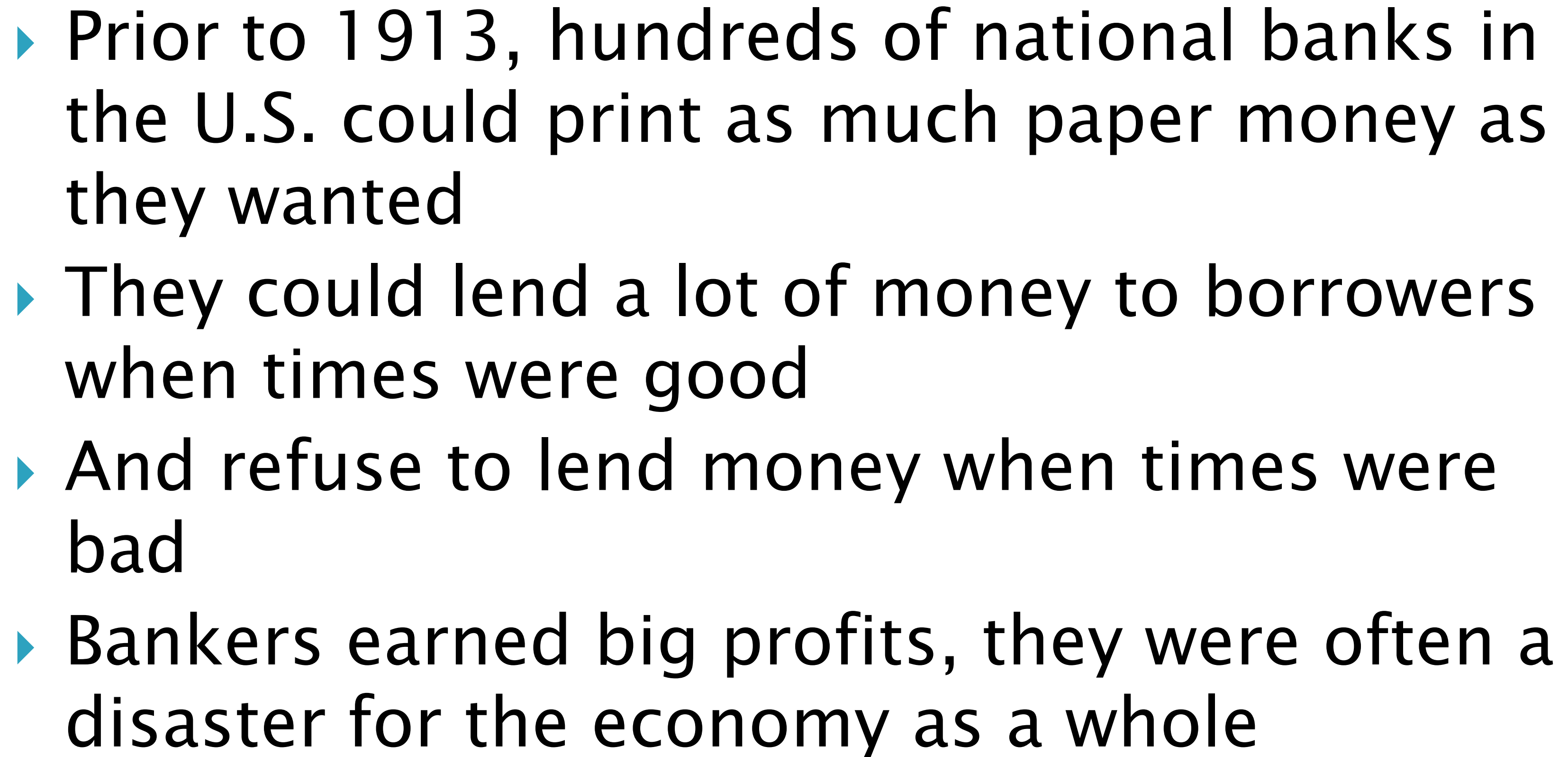


- Prior to 1913, hundreds of national banks in the U.S. could print as much paper money as they wanted
- They could lend a lot of money to borrowers when times were good
- And refuse to lend money when times were bad
- Bankers earned big profits, they were often a disaster for the economy as a whole

# The Federal Reserve System

- That is why the Federal Reserve System (often called “the Fed”) was established
- Established in 1913, its main job is to set monetary policy
  - To regulate the amount of money available in the economy
  - Promote economic growth
  - full employment
  - to limit the impact of inflation and recessions

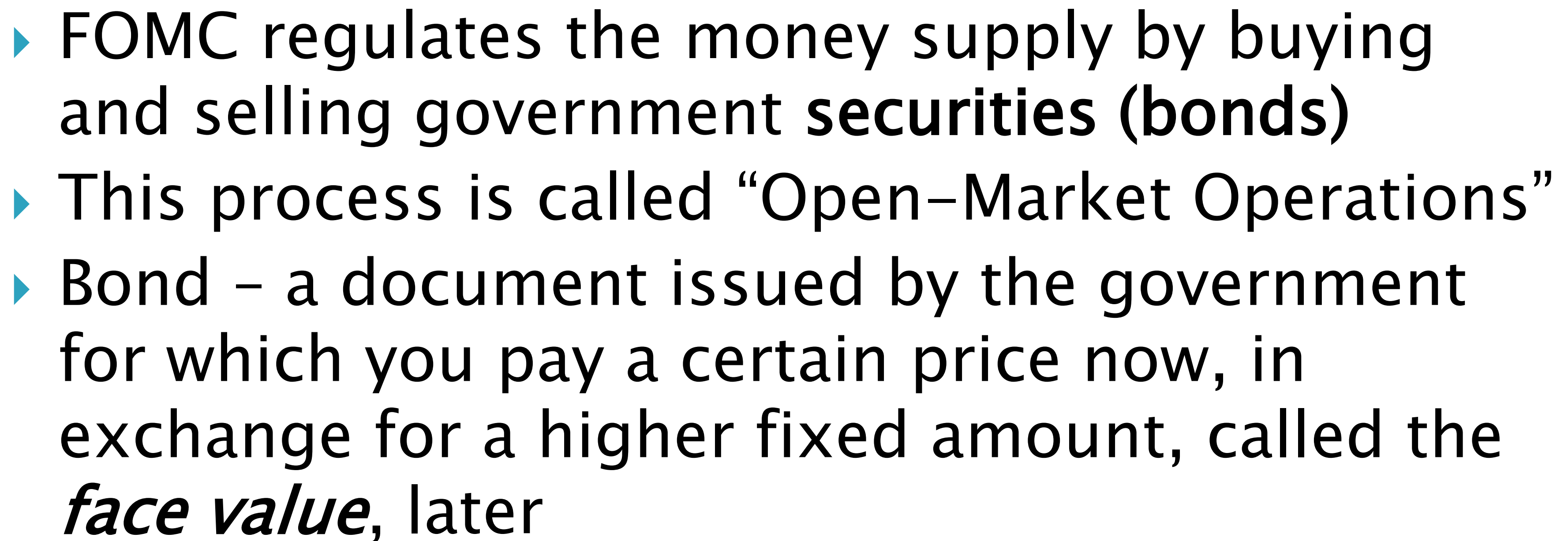
# The Federal Reserve System

- Another important job of Fed:
  - To make and enforce rules about what banks can and cannot do
    - What percentage of a bank's deposits must be held as **reserves** (cash available for withdrawals, rather than being invested)
  - Many bank's reserves are held by the Fed itself and transferred to individual banks as needed

# The Federal Reserve System

- Often called the nation's "central bank"
- It is actually a system of twelve different banks in different regions of the nation
- Each bank prints paper currency (money) called Federal Reserve Notes
- The Federal Reserve System is run by a Board of Governors
  - Appointed by the U.S. president
- Monetary policy of the Fed is decided by a group called the Federal Open Market Committee (FOMC)

# How and Why the Fed Regulates the Money Supply



- FOMC regulates the money supply by buying and selling government **securities (bonds)**
- This process is called “Open-Market Operations”
- Bond – a document issued by the government for which you pay a certain price now, in exchange for a higher fixed amount, called the *face value*, later

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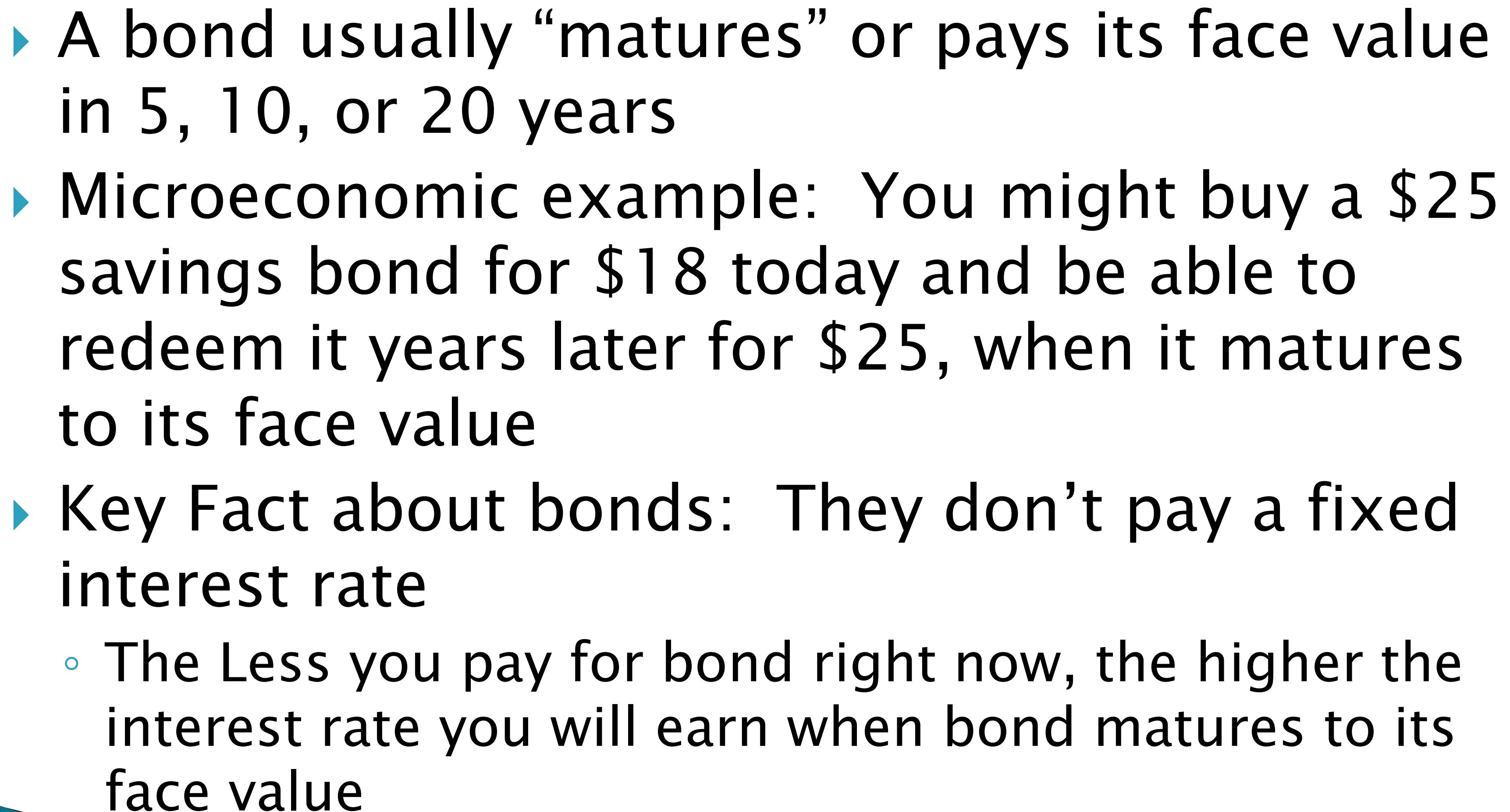
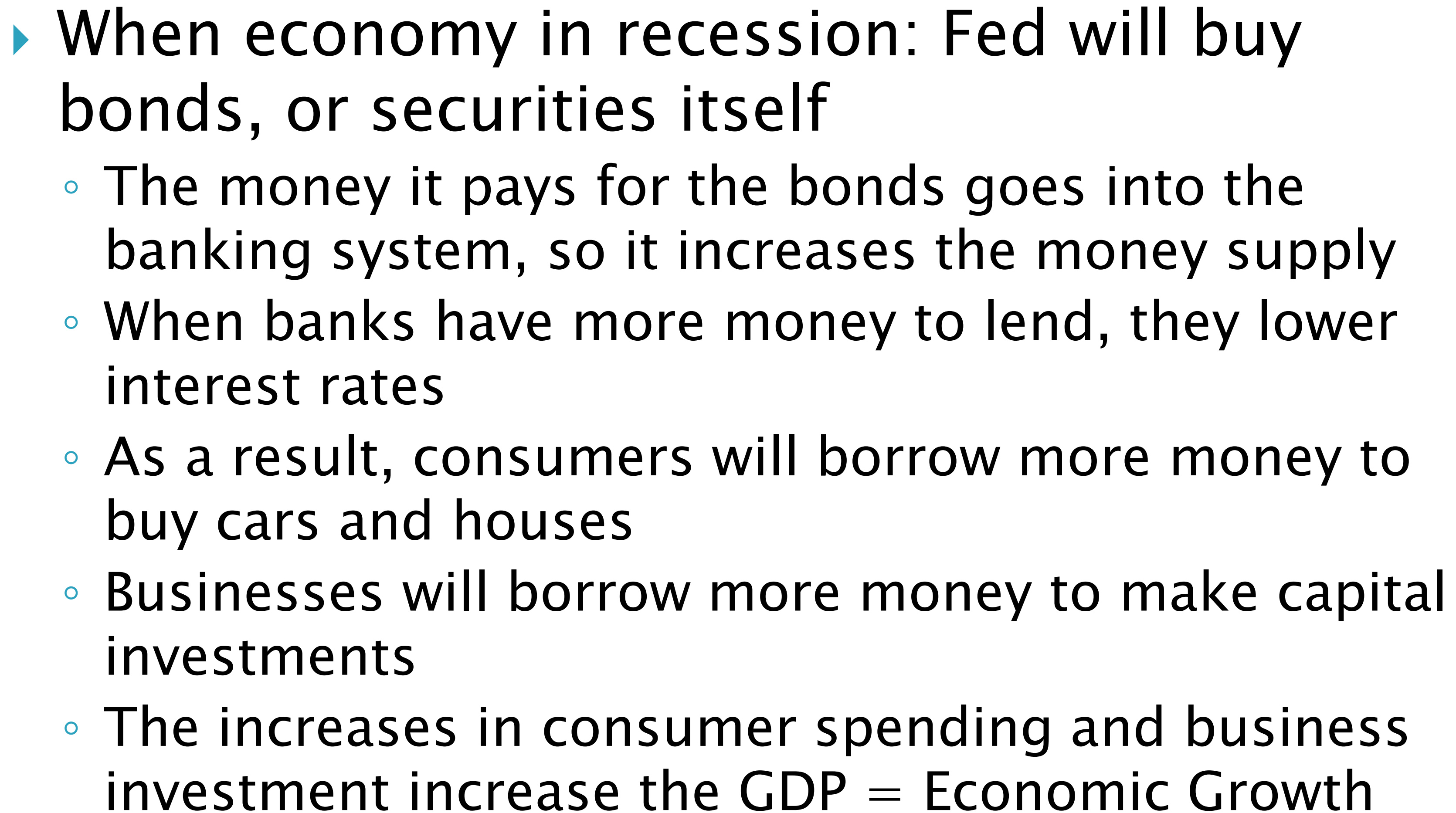


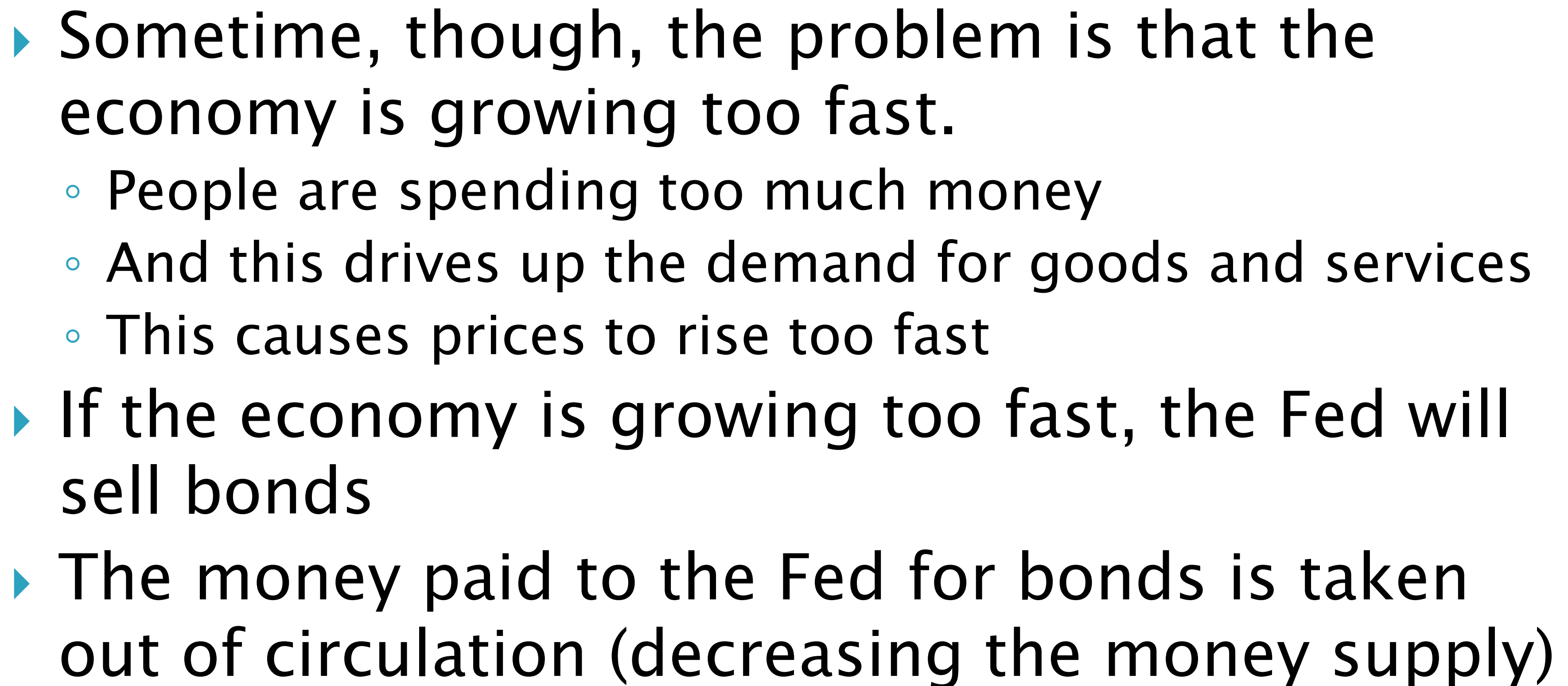
- A bond usually "matures" or pays its face value in 5, 10, or 20 years
- Microeconomic example: You might buy a $25 savings bond for $18 today and be able to redeem it years later for $25, when it matures to its face value
- Key Fact about bonds: They don't pay a fixed interest rate
  - The Less you pay for bond right now, the higher the interest rate you will earn when bond matures to its face value

# How and Why the Fed Regulates the Money Supply



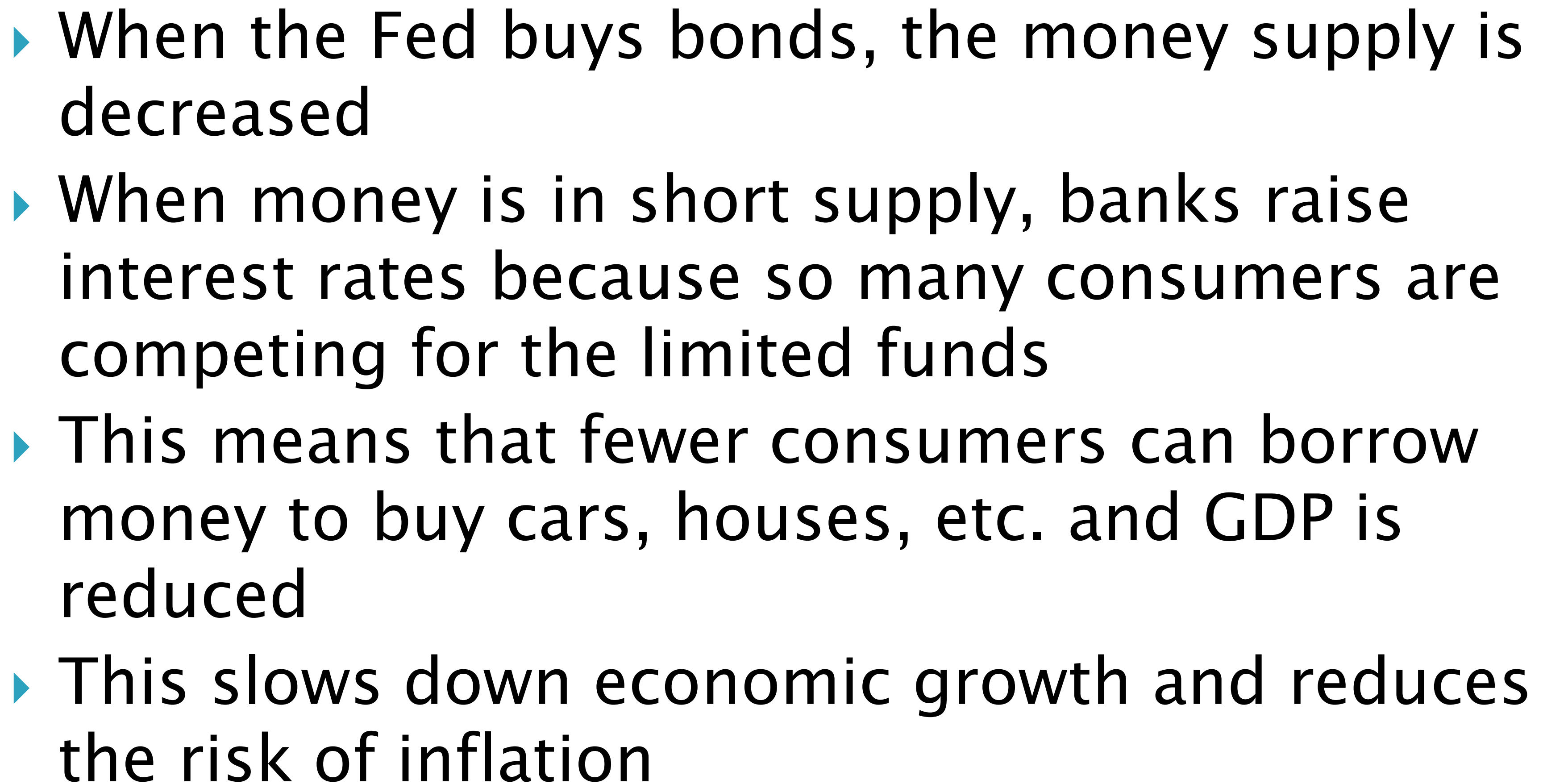
- When economy in recession: Fed will buy bonds, or securities itself
  - The money it pays for the bonds goes into the banking system, so it increases the money supply
  - When banks have more money to lend, they lower interest rates
  - As a result, consumers will borrow more money to buy cars and houses
  - Businesses will borrow more money to make capital investments
  - The increases in consumer spending and business investment increase the GDP = Economic Growth

# How and Why the Fed Regulates the Money Supply



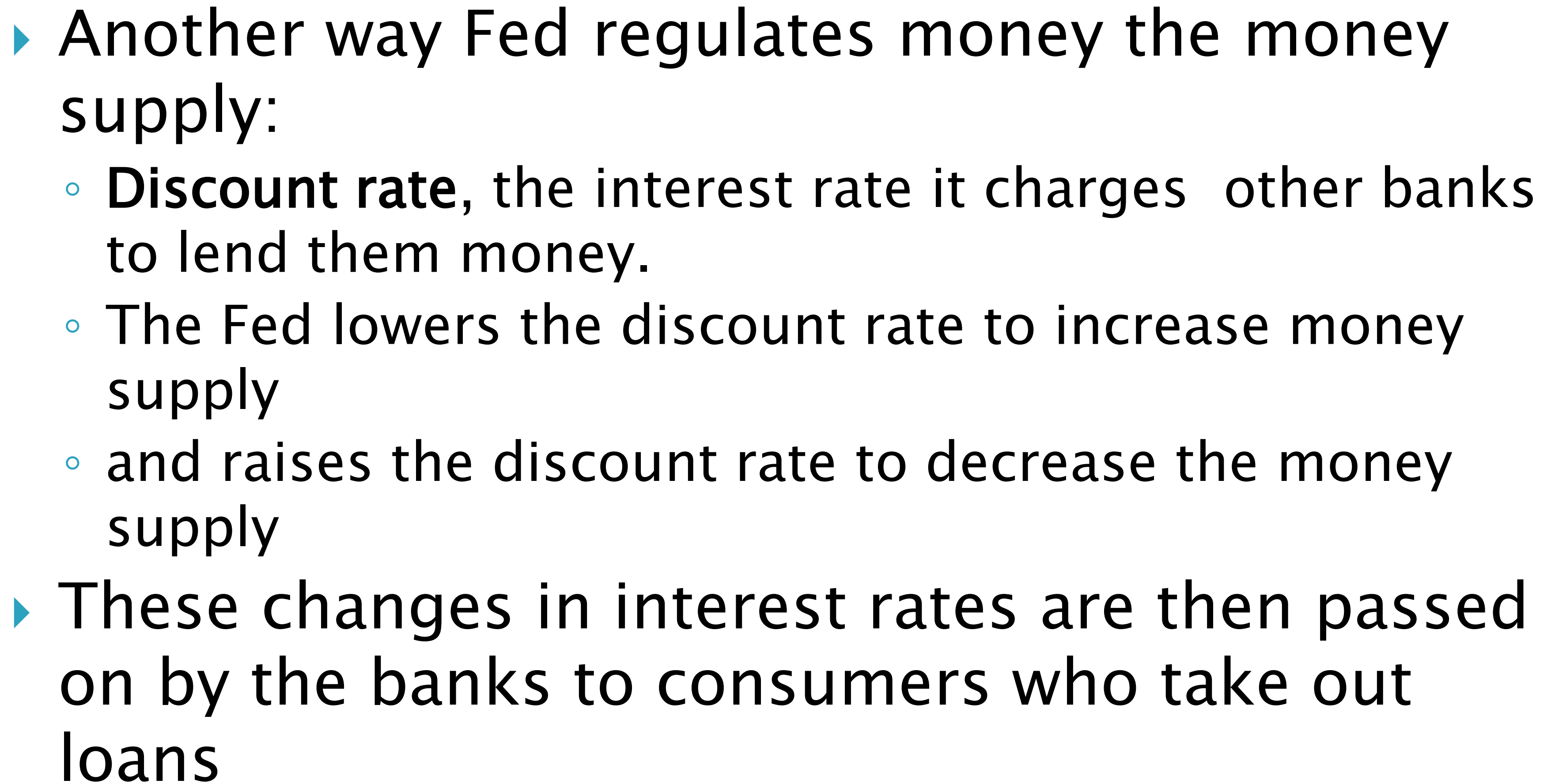
- Sometime, though, the problem is that the economy is growing too fast.
  - People are spending too much money
  - And this drives up the demand for goods and services
  - This causes prices to rise too fast
- If the economy is growing too fast, the Fed will sell bonds
- The money paid to the Fed for bonds is taken out of circulation (decreasing the money supply)

# How and Why the Fed Regulates the Money Supply



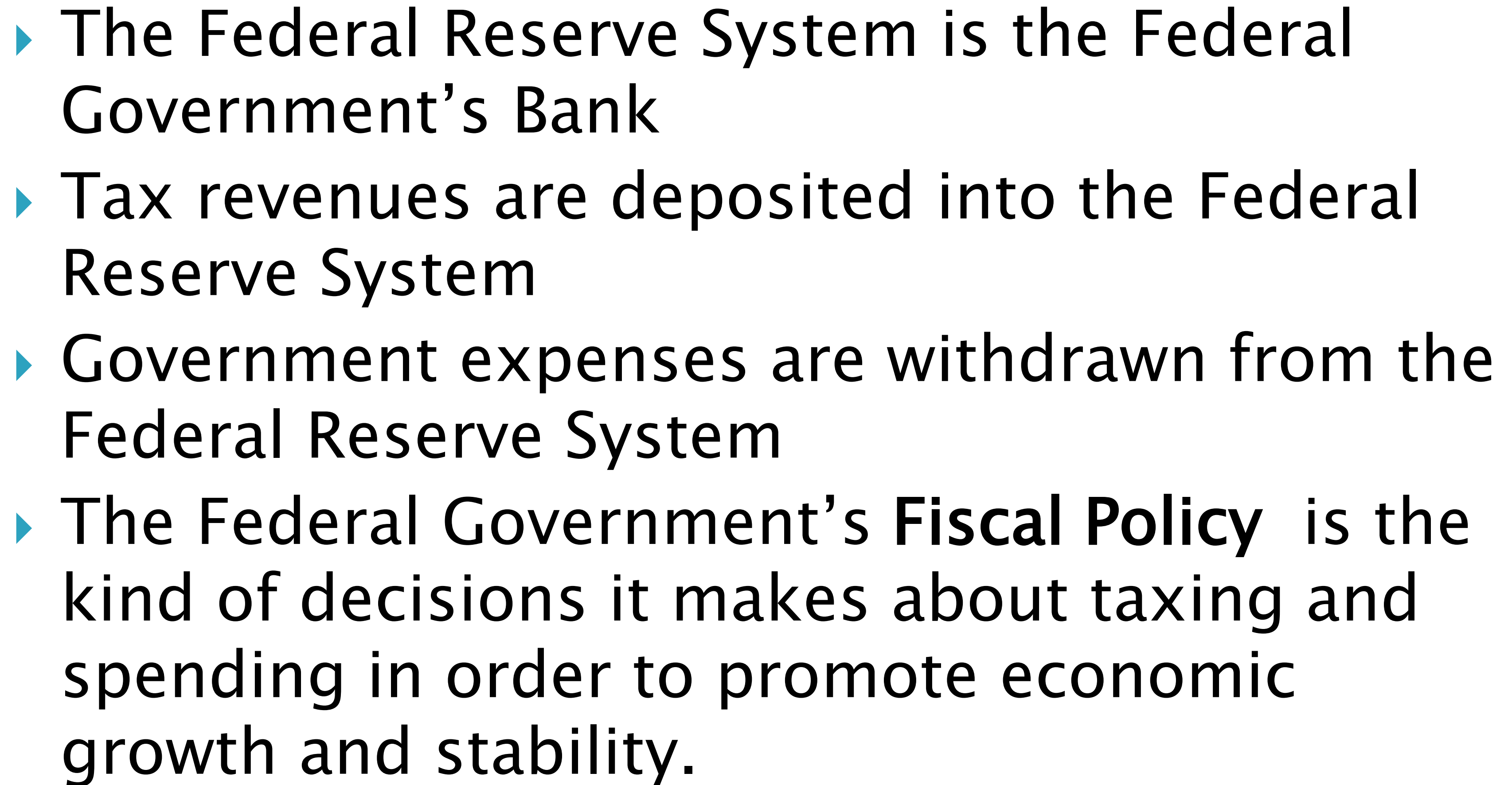
- When the Fed buys bonds, the money supply is decreased
- When money is in short supply, banks raise interest rates because so many consumers are competing for the limited funds
- This means that fewer consumers can borrow money to buy cars, houses, etc. and GDP is reduced
- This slows down economic growth and reduces the risk of inflation

# How and Why the Fed Regulates the Money Supply



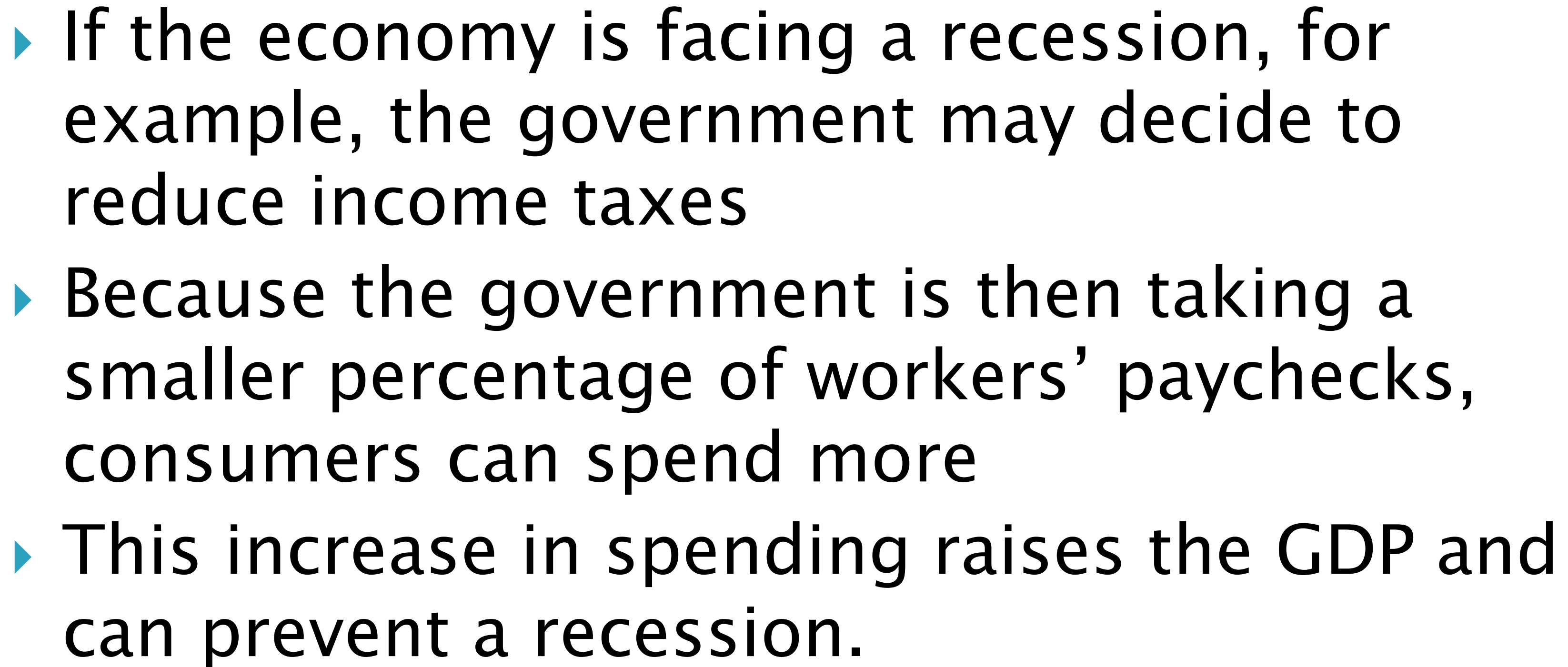
- Another way Fed regulates money the money supply:
  - **Discount rate**, the interest rate it charges other banks to lend them money.
  - The Fed lowers the discount rate to increase money supply
  - and raises the discount rate to decrease the money supply
- These changes in interest rates are then passed on by the banks to consumers who take out loans

# Fiscal Policy



- The Federal Reserve System is the Federal Government's Bank
- Tax revenues are deposited into the Federal Reserve System
- Government expenses are withdrawn from the Federal Reserve System
- The Federal Government's **Fiscal Policy** is the kind of decisions it makes about taxing and spending in order to promote economic growth and stability.

# How and Why the Fed Regulates the Money Supply



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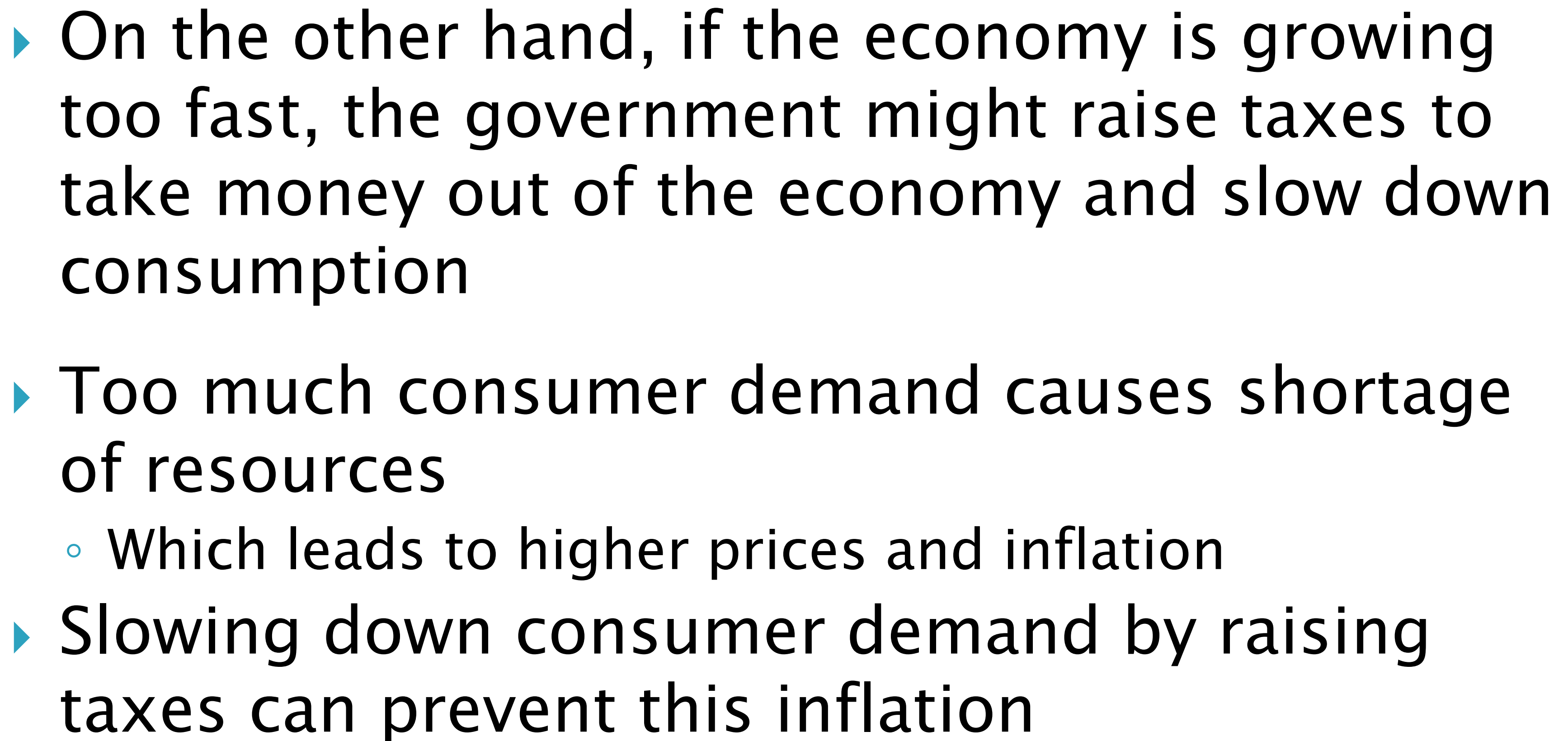
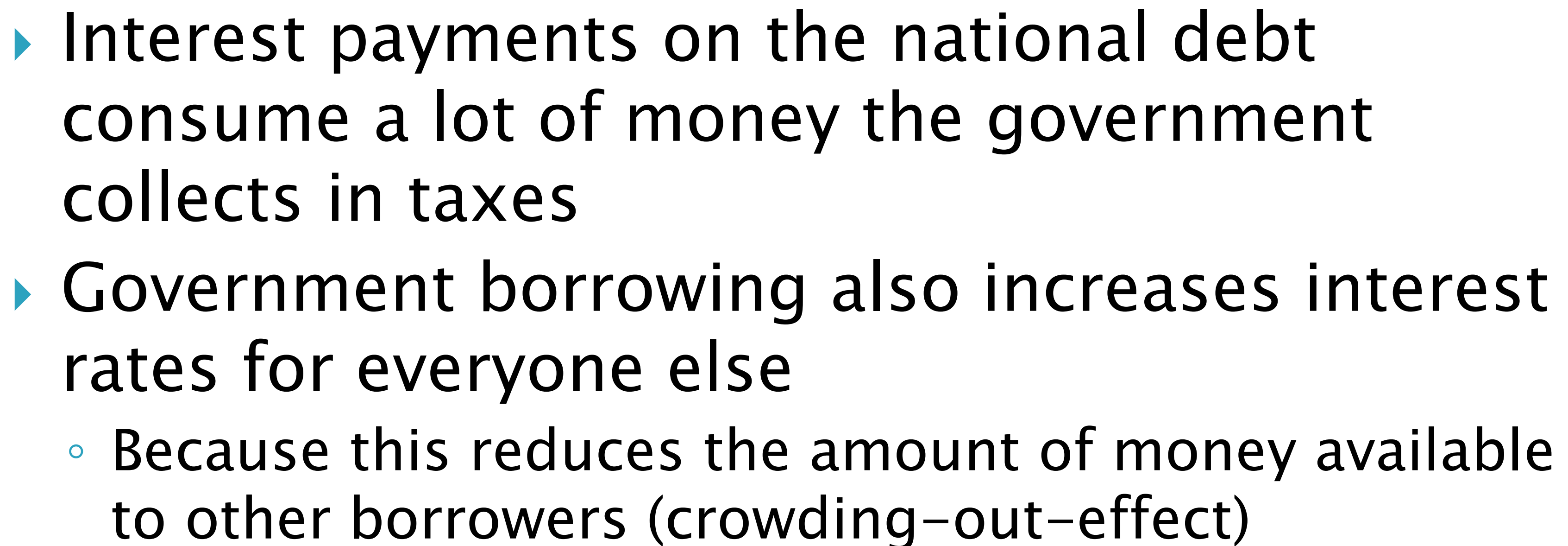


# How and Why the Fed Regulates the Money Supply

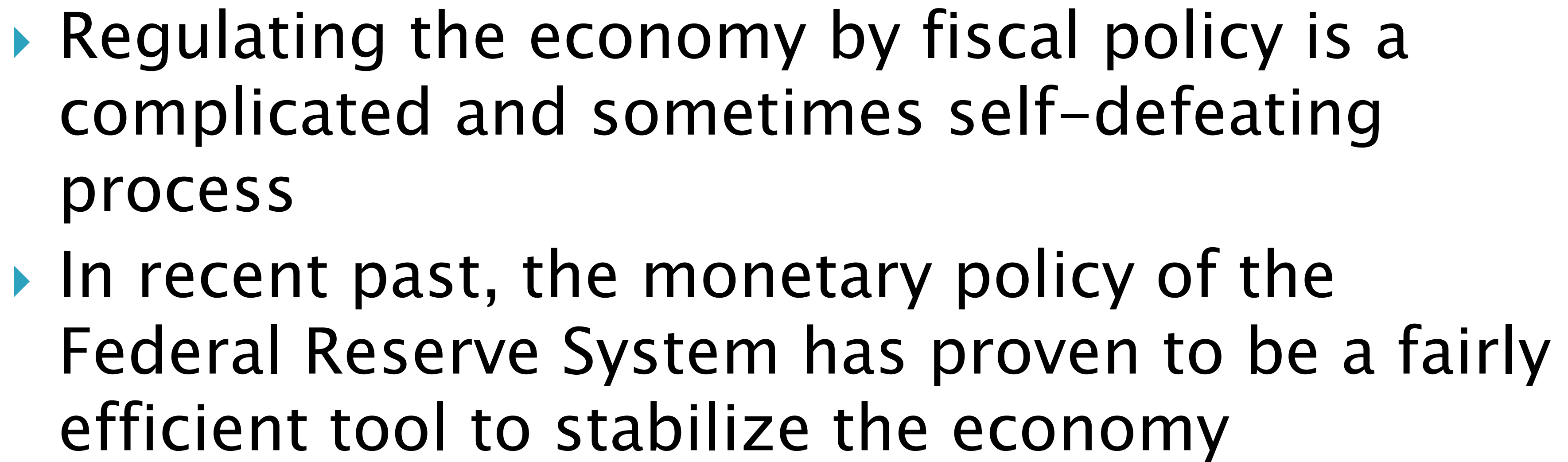
- Since the GDP = C+I+G+Xn
  - The government can also regulate GDP by increasing or decreasing its own spending
- If the government cuts taxes and increases spending at the same time
  - the result could be a budget deficit
- This deficit spending does speed up economic growth, at least in the short term
- Every time the government has to borrow money to make up for a deficit, however, it increases the national debt

# How and Why the Fed Regulates the Money Supply



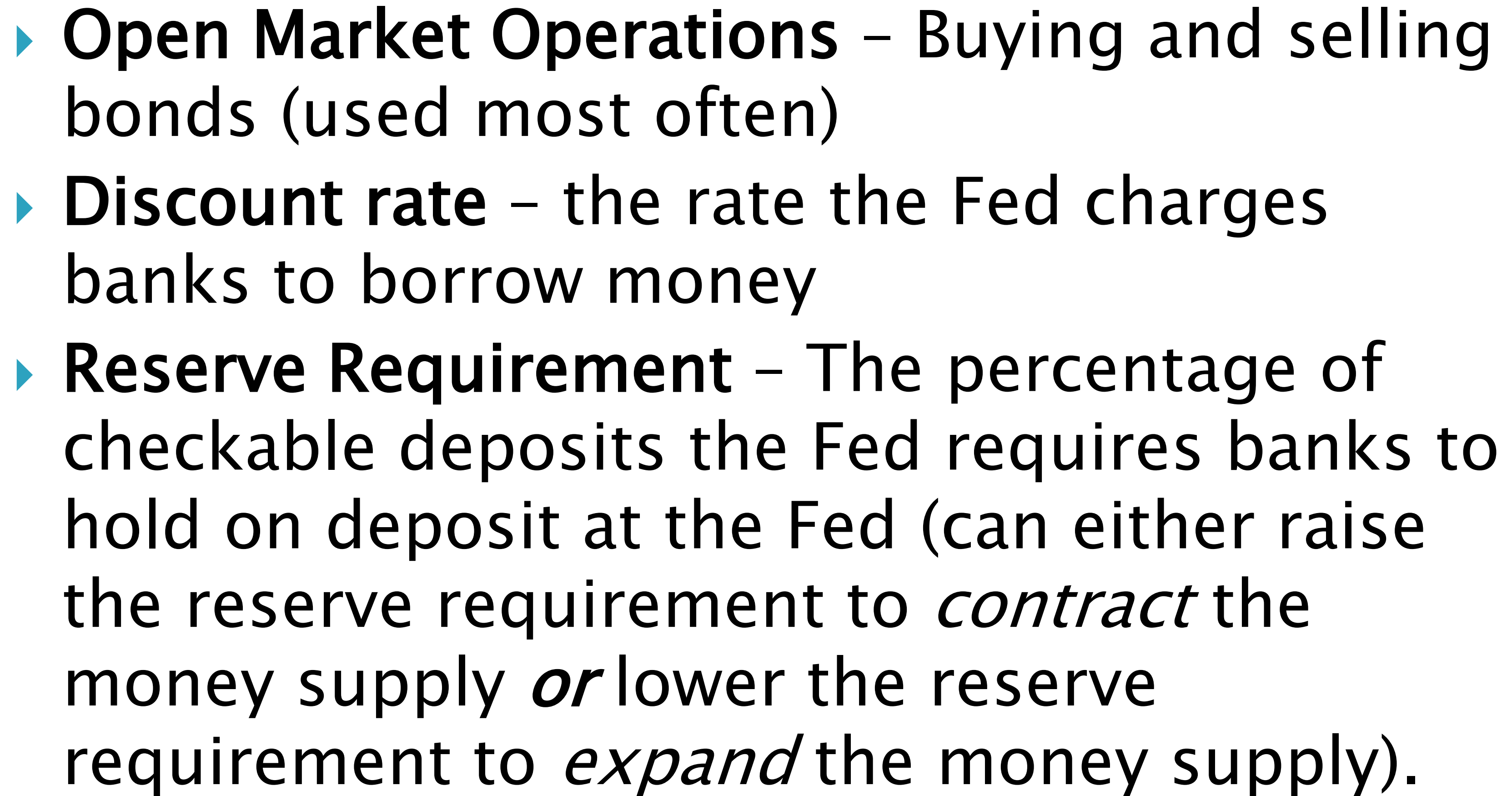
- Interest payments on the national debt consume a lot of money the government collects in taxes
- Government borrowing also increases interest rates for everyone else
  - Because this reduces the amount of money available to other borrowers (crowding-out-effect)

# How and Why the Fed Regulates the Money Supply



- Regulating the economy by fiscal policy is a complicated and sometimes self-defeating process
- In recent past, the monetary policy of the Federal Reserve System has proven to be a fairly efficient tool to stabilize the economy

# Monetary Policy Tools



# Question 1

- Which of the following is responsible for the monetary policy in the U.S.
  - A. Congress
  - B. the president
  - C. the Senate
  - D.  The Federal Reserve